RI 37-15

FEDERAL INCOME TAX INFORMATION

The following information about the Federal income tax on annuities and the lump sum payment of retirement contributions under the alternative annuity option has been provided by the Internal Revenue Service (IRS). The Office of Personnel Management (OPM) cannot provide you with tax advice or information beyond that which is contained in this notice. This is the most current information provided to OPM by the IRS. For assistance in determining how you should compute or pay your Federal income taxes, you should contact your tax advisor or the local IRS office. Local IRS listings are found in your local telephone directories.

The information which accompanies your Alternative Annuity Election form refers to IRS Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits*, for information on the taxation of monthly annuity payments, as well as lump sum payments which you may elect. The IRS has provided the following general information about these matters; these guidelines are more fully explained in IRS Publication 721.

Under the Civil Service Retirement law, payments must be made to the Retirement Fund for periods of service for which retirement contributions were not withheld (deposits) and periods of service for which retirement contributions were withheld and later refunded (redeposits) in order to receive maximum credit for such service.

Under the Federal Employees' Retirement System (FERS) law, payments must be made to the Retirement Fund for periods of service prior to 1989 for which retirement contributions were not withheld (deposits) in order to receive maximum credit for such service. Periods of service performed on or after January 1, 1989, for which no retirement contributions were withheld and periods of service for which retirement contributions were withheld and later refunded (redeposits) cannot be paid for or used to increase the amount of FERS annuity.

Once paid, these deposits and redeposits become a part of that person's retirement contributions.

In cases where a deposit or redeposit is owed at retirement and a person elects an alternative annuity, OPM regulations avoid the necessity of collecting deposit and redeposit monies which would simply be returned as part of a person's lump sum payment. Instead, the regulations give the person automatic credit for deposits and/or redeposits owed to the Retirement Fund, including interest.

Giving automatic credit for the amounts owed assures that the person's alternative annuity is the maximum amount possible. These amounts are then treated as though they had been paid to OPM and then returned to the person as part of the lump sum payment -- these are "deemed" deposits and redeposits.

Lump sum payments under the alternative annuity option are subject to Federal income tax. If you elect the alternative annuity option, you will be paid a lump sum equal to: 1) all of the contributions that remained to your credit in the Civil Service Retirement Fund at the time of your retirement and 2) interest earned on retirement contributions that were withheld from your pay before January 1, 1957. However, for Federal income tax purposes your lump sum credit will also include: 3) any deemed deposits for Federal employment during which no retirement contributions were withheld from your pay (plus applicable interest) and 4) any deemed redeposits for any refunds of retirement contributions that you have received, but have not repaid (plus applicable interest).

CALCULATING THE TAXABLE PORTION OF YOUR MONTHLY ANNUITY

Monthly annuity payments which start on or after July 2, 1986, are taxed under the "general rule," that is, a portion of each annuity payment is taxable and a portion is a tax-free return of your contributions.

However, you may be able to use a simpler computation instead of the general rule to figure the tax-free part of your annuity. To compute the tax-free portion of each monthly annuity payment using the simplified method, divide the amount of your retirement contributions (including any unpaid deposit or redeposit if you are electing the alternative annuity) by the appropriate factor shown below:

If you were:	Divide By:
55 and under	300
56 - 60	260
61 - 65	240
66 - 70	170
71 and over	120

For example, if your retirement contributions were $25,000 and you were age 57 at retirement, the portion of each annuity payment that is not taxable is $96.15 ($25,000 ÷ 260 = $96.15). If you received monthly annuity payments for 10 months during the year, $961.50 of your total annuity payments for the year would be tax-free.

In the following year, if you received 12 monthly annuity payments, your total tax-free amount for that year would equal $1,153.80 ($96.15 x 12). At the end of the second year, you have used up $2,115.30 ($961.50 + $1,153.80) of your total retirement contributions. You continue to treat $96.15 of each monthly annuity payment as tax-free until you have used up your total retirement contributions including deemed deposits and redeposits. Thereafter, your annuity is fully taxable.

CALCULATING THE TAXABLE PORTION OF YOUR LUMP SUM

Usually, 85 to 95 percent of the lump sum credit is taxable income. To determine the exact portion of the lump sum credit that is not taxed, you must find the difference (reduction amount) between the largest regular monthly annuity amount and the alternative annuity amount available to you. The difference is then divided by the amount of the largest regular monthly annuity payment (the greater of Option 1A or Option 1B shown on the Alternative Annuity Election form, RI 20-80).

The resulting percentage is the percentage of your adjusted investment that is **not** subject to Federal income tax. Your adjusted investment is determined by subtracting from the lump sum credit any pre-1957 interest and the tax-free portion of any prior monthly annuity payments you have received. For example, if the largest regular annuity available to you was $1000 and you elected an alternative annuity of $915 (and a lump sum payment), the $85 difference would be divided by $1000 to determine that .085 or 8.5 percent of your adjusted investment would not be taxed; the remaining portion of your lump sum would be taxable. The formula described in this paragraph is:

$$\frac{\text{Reduction amount}}{\text{Original monthly rate}} \times \text{Adjusted investment} = \text{Tax-free portion of lump sum credit}$$

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PM 1.10:

Your adjusted investment is the total amount of your contributions to the retirement fund (including any deemed deposits or redeposits) less the tax-free portion of any annuity payments you received before you were paid your lump sum. The formula above will give you the exact tax-free amount of your lump sum credit.

Example: Suppose you use the simplified method of computing the tax-free portion, and your total retirement contributions (including any deemed deposits and redeposits) equal $20,000. Suppose further that you had received five annuity payments before receiving your lump sum payment and that the tax-free portion of each payment under the simplified method is $80. By subtracting $400 (five times $80) from $20,000, you would derive an adjusted investment of $19,600. Lastly, assume that your largest regular monthly annuity payment (from RI 20-80) is $1000 and your alternative annuity is $915, making the annuity reduction $85. Then to determine the tax-free portion of your lump sum credit, you would apply the above formula as follows:

$$\frac{\$\ 85}{\$\ 1{,}000} \times \$19{,}600 = \$1{,}666$$

Tax-free portion of lump sum credit

Thus, $18,334 ($20,000 minus $1666) of your lump sum credit would be taxable income.

ANNUITY COMMENCING ON OR AFTER DECEMBER 3, 1989

If your lump sum is being paid in two installments, the tax-free portion of your lump sum credit must be divided between both installments in the same proportion that each installment bears to your total lump sum credit.

Thus, if there were no deemed deposits or redeposits in the example above, you would receive your $20,000 lump sum in two installments. For tax purposes, both installments would be $10,000. The second installment will include fully taxable interest. $833 of each installment would be tax-free (50 percent of the $1,666 tax-free portion of the total lump sum credit). Both installments are taxed in the year payments are made to you; this could be the same year. If you receive both installments in the same year, there is no need to determine the tax-free portion of each installment. Remember, if your lump sum credit includes a deemed deposit or redeposit, all of the deemed deposit or redeposit is considered paid to you with the first lump sum installment. This means that more than 50 percent of the tax-free portion will be allocated to the first installment. The following two examples are provided to show how the computation described above would be made with no deemed payments (example 1) and with deemed payments (example 2).

		EXAMPLE 1	EXAMPLE 2
a.	Contributions in fund	$ 20,000	$ 18,000
b.	Deemed payments	$ 0	$ 2,000
c.	**Lump sum credit**	$ 20,000	$ 20,000
d.	Total payable	$ 20,000	$ 18,000
e.	Initial installment	$ 10,000	$ 9,000
f.	**Initial installment for tax purposes**	$ 10,000	$ 11,000
g.	Ratio of initial installment for tax purposes to the lump sum credit	50%	55%
h.	Total tax-free portion	$ 1,666	$ 1,666
i.	Tax-free amount of first installment	$ 833	$ 916.30
j.	Tax-free amount of second installment	$ 833	$ 749.70

ANNUITY COMMENCING ON OR AFTER JANUARY 4, 1988, AND BEFORE DECEMBER 3, 1989

If your lump sum payment is being paid in two installments, the tax-free portion of your lump sum credit must be divided between both installments in the same proportion as each installment bears to your total lump sum credit.

If two installments are paid, the first installment is 60 percent of the lump sum and is payable after OPM receives your election; the remaining 40 percent is payable one year after your retirement date. If you receive an initial installment of 60 percent (rather than the 50 percent shown in the example above), you can determine the tax-free portion of each installment by multiplying your "Total tax-free portion" (item h in the example above) by 60 percent (if there are no deemed deposits or redeposits) or by the percentage you compute using Example 2 (if deemed deposit or redeposit is involved).

OTHER TAX CONSIDERATIONS

The lump sum credit is not eligible for the 5-year or 10-year averaging treatment. Furthermore, it generally may not be rolled over to an IRA or another qualified plan because the total amount you receive as a lump sum credit will be less than 50 percent of the total value of your annuity payments.

If you retire before the year in which you attain 55 years of age, you should also know that section 72(t) of the Internal Revenue Code imposes an additional tax of 10 percent of the taxable amount of your lump sum credit regardless of when it is paid. The additional 10 percent tax will not apply to the lump sum credit if you retire during or after the calendar year you attain age 55.

The interest paid with the second installment of the lump sum does not represent contributions, and therefore is not considered part of your lump sum credit for tax purposes. Any interest paid with the second installment of the lump sum is fully taxable, and will be combined with the gross amount of annuity we will report on the W-2P Statement of Annuity Paid for the year the second installment is paid.

Remember, OPM cannot provide you with advice on your Federal income tax liability. If you need assistance in determining the taxability of your annuity and/or lump sum payment under the alternative annuity option, you should contact your tax advisor or the Internal Revenue Service. This is the only income tax information that OPM has available.

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